

COMPLIANCE ALERT MUTUAL DIRECTORSHIPS

The following alert highlights some of the issues a director of multiple nonprofit organizations may encounter when presented with a business opportunity that creates a potential conflict of loyalties.

Conflict of interest issues can arise when a director of multiple nonprofit organizations learns of a potential business opportunity that may be relevant to one or more of the nonprofits. This alert provides guidance to such mutual directors, and the nonprofits they serve, about policies regarding disclosure of business opportunities.

Should you require further assistance or information, please call Public Counsel's Community Development Project at (213) 385-2977, extension 200. Our attorneys provide free legal assistance to qualified nonprofit organizations.

This alert should not be construed as legal advice. There are numerous other laws that California nonprofit organizations and their directors are subject to that are not included in this alert.

Corporate Opportunity Doctrine: Mutual Director Dilemma

Most nonprofit corporations would be thrilled to have directors who have deep connections in the community and with other nonprofit organizations. However, if a director (or a corporate officer, like a President or Executive Director) of one nonprofit corporation serves on the board of another corporation, the legal duties that he or she owes to each corporation may sometimes conflict because the director owes the same degree of loyalty and responsibility to each corporation. This alert highlights some conflict of interest issues that may arise when a director of multiple nonprofits learns of a potential business opportunity, and provides some guidance to nonprofit organizations and directors with respect to these conflicts.

May a director serve on the board of multiple nonprofit corporations?

Yes. There is no inherent conflict of interest or breach of fiduciary duty caused by an individual serving as a director or officer of multiple nonprofit corporations.

How does a conflict arise?

A potential conflict of loyalties may arise when an individual who serves on multiple nonprofit boards learns of a business opportunity that is relevant to one or more of the nonprofits.

- For example, imagine that a director of two nonprofit corporations learns in his or her private capacity of a fundraising opportunity that might benefit both nonprofits.
 - Is the director obligated to disclose the opportunity to either nonprofit?
 - If so, does the director owe a fiduciary duty to disclose the opportunity to both nonprofits?
 - If not, may the director allocate the opportunity to one nonprofit without disclosing it to the other?
- Conversely, imagine that the director, in his or her corporate capacity for one nonprofit, learns of a fundraising opportunity that might benefit both nonprofits.
 - If the director were to disclose the opportunity to the second nonprofit, would the director breach his or her fiduciary duty of loyalty to the first nonprofit?

What type of opportunity requires disclosure to a relevant corporation?

In general, when a director encounters a potential business opportunity, the director must disclose it to the corporation if the opportunity is deemed a “corporate opportunity” for that corporation.

- A corporate opportunity is generally one:
 - (1) that the corporation is financially able to take advantage of;
 - (2) that is within the corporation’s line of business;
 - (3) that the corporation has an interest or expectancy in; and
 - (4) that, if taken by the director for personal benefit or benefit of another, places the director in a position adverse to his or her duties to the corporation.
- A potential business opportunity generally is *not* a corporate opportunity if it is an opportunity:
 - (1) that the director learns of in his or her individual capacity and not in his or her corporate capacity;
 - (2) that is not essential to the corporation;
 - (3) in which the corporation holds no interest or expectancy; and
 - (4) in which the director has not wrongfully employed the resources of the corporation in developing or acquiring the opportunity.

May a director appropriate a business opportunity for him or herself, or allocate a business opportunity to another person or entity?

A director *may* appropriate a business opportunity if *either*:

- (1) the director, after analyzing the surrounding circumstances under the tests stated above, determines that the business opportunity is not a corporate opportunity for any corporation he or she serves; *or*
- (2) the director discloses the opportunity to the board and the board decides not to pursue the opportunity.

When and to whom does a director have a duty to disclose in the mutual director scenario?

When a director serves on more than one board, the director must determine to which nonprofit, if any, he or she owes a fiduciary duty to disclose an opportunity, and from which board, if any, must he or she seek approval to pursue a transaction on behalf of another nonprofit.

- A director is required to disclose an opportunity if it is a corporate opportunity for any of the nonprofits that the director serves.
- Where an opportunity is a corporate opportunity for one, but not all, of the nonprofits that a director serves, he or she must disclose the opportunity to the appropriate nonprofit, and withhold disclosure from all of the other nonprofits.
- If a business opportunity does not constitute a corporate opportunity for any nonprofit that the director serves, the director is free to exercise his or her judgment as to which nonprofit, if any, the director will disclose the opportunity.
- Although the corporate opportunity doctrine does not require directors to disclose every business opportunity they learn about, disclosure generally acts as a shield to protect a director from liability.

Should a director disclose an opportunity even if not required to do so?

Even where disclosure is not required, a director may decide to even the playing field by disclosing the opportunity to all of the nonprofits the director serves. Directors should carefully consider the possible consequences of such disclosure.

- In the context of grants or donations, such equal disclosure might be the best approach, because each nonprofit will have an equal opportunity to compete for funding.
- However, in the context of real property, personal property, or other tangible interests, competition may drive up the cost of an opportunity, and thus disclosure may hinder each nonprofit's ability to take advantage of the opportunity, or may make an opportunity less attractive.
- Another potential adverse effect of disclosure is that a director who serves multiple nonprofits that decide to compete for the same business opportunity might be precluded from participating in the acquisition of that opportunity on behalf of any of the nonprofits, because such competition creates a conflict of loyalties, and thus a conflict of interest. If the opportunity is contingent upon the director's involvement, then prohibiting the director from participating may cause all of the nonprofits to lose the opportunity.

Should a corporation initiate a policy requiring its directors to disclose every corporate opportunity?

- Disclosure is not required if a business opportunity is not a corporate opportunity. However, a conflict can arise if an opportunity is presented to a director in his or her corporate capacity for one nonprofit, but the opportunity represents a corporate opportunity for more than one of the nonprofits that the director serves. If a nonprofit requires a director to disclose a corporate opportunity of another nonprofit, the director may be forced to breach his or her fiduciary duty of loyalty to the initial nonprofit, and this may create a conflict of interest.

- Due to the potential exposure to liability for breach of the duty of loyalty or conflict of interest, the practical effect of a forced disclosure policy might be:
 - (1) to force a director to serve on only one board; or
 - (2) to preclude a director from participating in business opportunities that may benefit the nonprofits he or she represents.

How can a nonprofit grant its directors the flexibility to allocate corporate opportunities?

In order to alleviate concerns directors might have about serving on multiple boards, a nonprofit might consider adopting a bylaw provision that allows its directors freedom to allocate corporate opportunities among the nonprofits they serve.

- Such a provision would likely encourage, rather than discourage, potential directors to volunteer, by lessening concerns over conflict of loyalties and conflicts of interest, because if a director learns of any potential opportunity, and either discloses the opportunity or takes the opportunity for another nonprofit, the director will be acting under a clearly defined corporate policy that indicates the corporation does not have an interest or expectancy in corporate opportunities of other nonprofits the director serves.
- Such a provision might state: “Directors of this corporation may hold positions as officers and directors of other corporations in related businesses. A director’s efforts to advance another corporation’s purpose will not constitute a conflict of interest or a breach of fiduciary duty to this corporation absent a showing of bad faith.”